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Pensions and Passivity

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PENSIONS AND PASSIVITY

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I
INTRODUCTION

One of Equity's least-discussed triumphs[1] is also one of its most significant: passive ownership of property. Passive ownership of property has become the dominant mode of owning capital in the United States. It has triumphed over its great rival, the classical liberal model of property ownership. That model, which the common law of property historically promoted,[2] consolidated in a single legal entity, usually an individual person, the relevant rights, privileges, and powers for possessing, using, and transferring assets. The passive model of ownership deviates from classical ownership by disaggregating beneficial property rights from the control and management functions of ownership. Under the passive model, beneficial owners of property rights lack the authority to decide how the assets in which they have a beneficial interest are used.

Equity first developed the passive model of ownership through its enforcement of trusts.[3] The trust's separation of property management from beneficial enjoyment provided, in turn, the precedent for the equitable institution that vastly extended the incidence of passive ownership, the corporation.[4] As Berle and Means's classic discussion demonstrated,[5] the rise of the modern corporation signalled a fundamental change in the character of ownership in mature capitalist economies. Prior to the emergence of the modern corporation, individuals who supplied capital for enterprises retained extensive control over

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1. While the phenomenon of passive ownership has been widely discussed, its origin as part of equity's tradition is much less commonly remarked. On the successes of equity in general, see Douglas Laycock, *Equity's Triumphs*, 56 Law & Contemp. Probs. (forthcoming Summer 1993).

2. *See* Charles Donahue, Jr., *The Future of Property Predicted from Its Past*, *in* Nomos XXII: Property 28 (J. Roland Pennock & John W. Chapman eds., 1980).

3. I include here the medieval *use* in the term "trusts," although there are technical differences between them. The standard account of the rise of the trust is 2 Sir Frederick Pollock & Frederick William Maitland, The History of English Law 228-32 (2d ed. 1911).

4. *See* Colin Arthur Cooke, Corporation, Trust and Company: An Essay in Legal History 69-72 (1950).

5. *See* Adolf Augustus Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

the use of the capital. Entrepreneurship and even professional management of firms were consistent with the consolidated model of ownership insofar as capital suppliers retained power over their capital. Investors in modern corporations, by contrast, have no personal stake in the firms in which they are invested; they have little or no say in management decisions, and they suffer no exposure to losses greater than the amount of their investment.

This article discusses how modern fiduciary law has extended equity's tradition of constructing ownership as passive through the corporate pension system. It examines how the corporate pension system as a mode of owning pooled capital is a new stage of passive ownership. This stage creates a different aspect of the familiar problem of separating control from beneficial ownership. Berle and Means argued that the problem that the separation of control from ownership created was economic. The interests of managers and shareholders in the modern corporation diverge, and, they argued, this divergence diminishes the overall efficiency of the modern economy, dominated as it is by large corporations.

This article argues that passive ownership, as constructed under current pension law, creates a problem that is more political and moral than economic. In addition to constructing beneficial ownership as passive, pension law exhibits a strong paternalistic attitude toward plan participants, much more so than corporation law exhibits toward shareholders. This combination of passivity and paternalism denies pension participants the political and moral virtues that historically have been associated with the two great models of ownership that have competed since the nineteenth century: liberalism and socialism.

Paradoxically, some commentators describe pension ownership in terms that are consistent with the core tenets of classical liberalism,[6] while others have described it as a form of socialism. The main exponent of the latter view is the management theorist Peter Drucker, whose book *The Unseen Revolution*[7] first developed the thesis that the rise of pension funds has transformed the U.S. economy into a socialist economy.[8] This article argues that neither of these characterizations is accurate. Beneficial interests in pensions deviate in crucial ways from the conceptions of ownership under both classical liberalism and classical state socialism. The form of beneficial ownership of capital that the pension system represents fails to realize the political and moral visions embedded in the classical liberal and socialist models of ownership.

More specifically, the principal thesis of this article is that the passive and paternalistic mode of ownership[9] that the pension system has created diminishes

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6. *See* John H. Langbein & Bruce Wolk, Pension and Employee Benefit Law 24 (1990) (characterizing beneficial pension ownership in contractarian terms).

7. Peter F. Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America (1976). Drucker first articulated his pension-fund socialism thesis in an essay, *Pension Fund "Socialism,"* PUB. INTEREST, Winter 1976, at 3.

8. *See infra* part III.

9. It is important to distinguish between passivity and paternalism. While some aspects of pension law's model of passive ownership exhibit a paternalistic outlook, other aspects of the model do not

the degree of personal responsibility that classical liberal ownership required all individual owners to take. At the same time, despite its group-like character, the corporate pension system, unlike classical socialism, contains no features that allow, let alone guarantee, democratic participation by the group.[10] Indeed, its defining characteristics are calculated to inhibit direct participation by pension owners in important decisions regarding the use of pension capital.

While the emergence of passive ownership under the modern corporate form initially posed the problem of passive ownership, the corporate pension system has exacerbated it. Pension participants have less power with respect to their plans than do shareholders with respect to their investments. One crucial difference is that participation in employer-sponsored plans through deferred compensation is largely involuntary, for paternalistic reasons.[11]

Paternalism in this context primarily takes the form of a system of tax subsidies to employer pensions designed to induce retirement savings when employees would otherwise not save. To be sure, this variety of paternalism is subtle, since it encourages rather than compels saving, but the paternalistic character of the subsidy system is there nonetheless. As Deborah Weiss has recently pointed out, "The Internal Revenue Code provides the highest ceilings on tax deductions to those pension programs that leave the least amount of room for individual choice regarding savings levels."[12]

A second difference between the modern corporate form and the pension system is that pension participants, unlike shareholders, may not freely exit from their plans.[13] Finally, plan participants also have less voice[14] in the internal

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involve paternalism. Arguments against the model of passive ownership thus must distinguish between objections to the model's paternalism and objections that focus on owner passivity as such.

Passivity does not necessarily entail paternalism, though paternalism usually involves passivity. A passive ownership regime is one in which individuals lack the power to practice self-governance, either because they have consensually delegated that power to others or because the state has denied them that power on the assumption that they are unable to calculate what is in their best interest. Only the latter reason for denying individuals decisional power involves paternalism.

10. Section 404(c) of ERISA permits plans in which the participant has some degree of control over assets in her individual account. 29 U.S.C. §§ 1001-1461 (1988). Section 404(c)(2) immunizes pension fiduciaries for losses that result from the participant's exercise of control. The Labor Department's proposed regulation states a § 404(c) plan is an individual account plan that

> [p]rovides an opportunity for a participant or beneficiary to exercise control over the assets in his individual account . . . and [p]rovides a participant or beneficiary an opportunity to choose, from a broad range on investments, the manner in which some or all of the assets in his account are invested . . . .

56 Fed. Reg. 10724 (1991) (to be codified at 29 CFR § 2550.404c-1) (proposed Mar. 13, 1991). Some § 404(c) plans, however, limit the participant's investment control by permitting participants to choose from a variety of different kinds of specified pooled investment funds. Participants have control only with respect to selection of the specified fund. They have no control over individual investment decisions by the fund's investment manager or the identity of the investment manager.

11. *See* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. Chi. L. Rev. 1275, 1279-85 (1991).

12. *Id.* at 1280.

13. *Id.* at 1282.

14. The terminology "exit," "voice," and "loyalty" was first developed by the economist Albert Hirschman to describe the decisional options theoretically available to members of large organizations in responding to a firm's policies: leave the organization; remain within the organization but express

management of their plans and in the use of the capital they contributed than do corporate shareholders,[15] whose voicelessness is widely acknowledged. The result is a mode of capital ownership that deviates from the classical models of property ownership even more than does stock ownership.

In Part II, this article briefly describes the corporate pension system. Part III critiques the pension-fund socialism thesis. Part IV examines the role of fiduciary law in constructing the passive model of beneficial ownership of capital. Part V develops the premise that an active, participatory form of individual ownership is usually desirable because it enables individuals to develop a sense of both personal and civic responsibility. Finally, Part VI considers practical constraints on realizing a more participatory form of pension ownership.[16]

II
THE PENSION ECONOMY: AN OVERVIEW[17]

A. The Magnitude of the Pension Economy and Its Inegalitarian Impact

Prior to the end of World War II, pension funds were relatively unimportant institutions. The enormous size and continuing growth of pension funds is indicative of their importance to the U.S. economy today. For example, in 1950, when General Motors first created its influential employee plan, pensions held less than one percent of all equity securities and only thirteen percent of all corporate debt.[18] By 1988, the combined assets in public (excluding federal)

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disagreement with the policy; or remain within the organization and concur with its policies. The metaphor of "voice" signifies participation in group decisionmaking. *See* Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Declines in Firms, Organizations, and States (1970).

15. *See infra* text accompanying notes 69-74.

16. There is an ambiguity in the notion of a participatory model of pension ownership that needs clarification. The concept of a participatory form of pension ownership has two possible meanings. One meaning refers to the idea that employees ought to be able to control decisions concerning the capital that they supply. This can be called "Model One". The other meaning is employees ought to have greater control over their employers, through the pension fund ownership of stock in the employer. This will be labelled "Model Two". According to Model Two, participatory pension ownership is a vehicle for realizing the broader political mission of workplace democracy, which Model One does not directly address. Realization of one model does not necessarily realize the other. For example, employees might have greater control over their capital through voting rights, but still prefer diversification over concentrated ownership because of their concern with minimizing portfolio risk. The two models of participatory ownership, then, must be evaluated separately. This article is primarily concerned with Model One, but it will incidentally address aspects of Model Two as well, particularly in Part VI.

17. The modern era of pension funds began after World War II with the series of pension plans negotiated for union workers in various industries, including mining, steel, and automobile (in 1950 for United Auto Workers union employees). Wage and price controls during the war deflected compensation demands into benefits, and this shift in the way employers competed for workers contributed to the enormous growth of corporate pensions after the war. Pensions were first created earlier, though. Historians usually cite the plan established in 1875 by American Express Company (which then was primarily involved in the railroad industry) as the first formal corporate pension plan. *See* William C. Greenough & Francis P. King, Pension Plans and Public Policy 27 (1976). The classic history of pre-modern pensions is MURRAY W. LATIMER, INDUSTRIAL PENSION SYSTEMS IN THE UNITED STATES (1932).

18. Richard A. Ippolito, Pensions, Economics, and Public Policy 123-24 (1986).

and corporate pension funds had reached $2.1 trillion.[19] This figure includes nearly one-quarter of all equity securities and one-half of all corporate debt. Pension funds are the largest source of investment capital for the U.S. economy.[20] Indeed, U.S. pension funds now constitute the largest single fund of private capital in the world.

Pension funds provide benefits to a substantial part of the U.S. workforce. In 1983, employer-sponsored pension plans covered 56.2 percent of the nonagricultural workforce.[21] If the employment base is adjusted to exclude part-time workers, self-employed workers, workers under age twenty-five and workers with less than one year on the job, the coverage rate rises to about seventy percent.[22]

At the same time, however, there are major gaps in pension coverage. These gaps alone make the "pension-fund socialism" label extremely misleading. The truth is that the current pension system is highly inegalitarian. Coverage varies significantly among industries and according to an employee's annual earnings. Coverage is highest in the public sector and, within the private sector, in the communications and utilities industries (eighty-one percent each in 1987). Excluding agriculture, coverage is lowest in nonunionized occupations such as retail sales (twenty-nine percent in 1987).[23]

Pension coverage also strongly correlates with employee earnings. As of 1983, while nearly eighty-four percent of employees earning $50,000 or more annually were covered by a private pension, among those earning $5,000 or less annually, only twenty-four percent were covered.[24] Vesting rates also correlate positively with wage levels.[25] These variances among income levels raise important wealth-distributive concerns. The result is that the current pension system benefits most those who need it least.

The tax side of pension law reinforces the inegalitarian character of the existing system by subsidizing pension savings with tax benefits that are largely regressive. These tax subsidies are instrumental in creating one of the more important conflicts of interest among pension participants: that between higher- and lower-bracket taxpayers. A truly egalitarian pension system would provide

19. Employee Benefit Research Institute, Investment of Pension Fund Assets 3 (1988).

20. *See* Jeremy Rifkin & Randy Barber, The North Will Rise Again: Pensions, Politics and Power in the 1980s 10 (1978).

21. Emily S. Andrews, Employee Benefit Research Inst., The Changing Profile of Pensions in America 49 (Tbl. III.1) (1985).

22. Lee A. Shepard, *Toward a Rational Pension Policy*, 37 Tax Notes 235 (1987).

23. *Id.*

24. Andrews, *supra* note 21, at 52. Coverage rates significantly increase above $15,000. While 58% of those earning between $10,000 and $14,999 annually were covered, nearly 72% of those whose annual earnings were between $15,000 and $19,999 were covered. *Id.*

25. Among covered employees whose annual earnings were $5,000 or below, less than 15% were vested. By contrast, more than 80% of covered employees earning above $50,000 were vested. One obvious reason why wage levels so strongly correlate with vesting is length of service. Employees earning low wages are less likely to have remained employed with the participating firm long enough to satisfy the vesting requirement. *Id.*

retirement security across all economic levels, but it would particularly focus on benefitting employees at the lower end of the wage scale.

Other factors that correlate with pension coverage also tend to undermine the democratic character of the pension system. Gender, for example, substantially correlates with pension coverage and further undermines the democratic character of the pension system. Women have lower levels of coverage and benefits than men.[26] This can be attributed to lower earnings levels among women, the pattern of interrupted participation by women in the workforce (due largely to child-rearing practices in the United States), and greater concentration of women employees in industries that have lower levels of pension coverage, such as retail sales.[27]

Unionization is another important correlative factor. In the private sector, the percentage of unionized workers covered is nearly double that of covered nonunion employees.[28] This means that nonunionist employees may be doubly exposed to economic insecurity, lacking both job and wage protection through collective bargaining and retirement income security. Nonunionization, moreover, intersects with gender as sources of economic insecurity. Women in the labor market have tended to cluster in occupations that are nonunionist and that lack pension coverage. The large number of women in pink-collar jobs, such as retail sales and secretarial work, illustrates this proposition.

Additionally, firm size strongly affects coverage. Large firms (more than 500 employees) are more likely to have pension plans than are small firms (fewer than 100 employees).[29] This is best explained by the greater probability that most, or at least many, employees in large firms are unionized.

B. Pension Types and Risk Allocation

Investors and financial planners classify pension plans in several ways. Pension plan classifications include public (for government employees), private, contributory (employees contribute along with employers), or private noncontributory, individual corporate or multiemployer, defined benefit or defined contribution.[30] The last distinction is the most important from the perspective

26. *Id.* at 62-69.

27. Pension recipiency among women is expected to increase in the future as a result of legal changes that have shortened the vesting period and demographic changes in the workplace. The rights of women have also been improved by legislation (the Retirement Equity Act of 1984) that substantially enhances the nonemployee spouse's pension rights when the marriage dissolves either through death of the employee spouse or divorce.

28. *Id.* at 62-65.

29. *Id.* at 49 (Tbl. III.1).

30. Another distinction is drawn between pension plans and welfare benefit plans, such as child care, life insurance, medical insurance, disability coverage, and similar provisions. Pension plans contemplate that the employee saves from her or his earnings over the course of employment, with the savings distributed to the employee upon retirement. Welfare benefit plans, by contrast, by and large are current expense undertakings. *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1111 (1988).

of democratic political theory, although it is also important from a classical economic perspective.

Defined benefit and defined contribution plans structure benefits in fundamentally different ways. Under defined benefit plans, participants receive specified benefits upon retirement. By contrast, defined contribution plans obligate employers going into the fund rather than going out, that is, they are obligated to make only a specified contribution into the fund, rather than to provide a specified amount as a benefit after retirement.

These two types of plans differ with respect to allocation of the investment risk. Defined benefit plans permit employees to receive a stated amount upon retirement, usually a monthly payment of a fixed amount for life. Thus, this type of plan allocates the investment risk to someone other than the employee. If invested pension funds fare poorly, the employer (or someone else, either the employer's insurer or the Pension Benefit Guaranty Corporation ("PBGC")) must make up the difference.[31] Conversely, if the investment performs better than expected, the employer's contributions will decrease.

Under defined contribution plans, employees do not receive a stated amount upon retirement. Rather, benefits are based on the amount that the employer has contributed to the plan. Under defined benefit plans, employers make contributions to individual accounts for each employee. The employee bears the risk for investments of her or his own account funds.[32] Financial planners frequently cite this feature as the reason defined benefit plans are more advantageous to employees. However, the supposed advantage of defined benefit plans is somewhat misleading. Defined benefit plans restrict mobility;

31. ERISA's scheme for insuring benefits where the fund has insufficient assets has limitations that leave employees exposed to part of the investment risk. For example, § 4022 imposes a cap on the maximum amount of the pension benefit that is insurable. If the plan participant's monthly benefit exceeds this cap, he or she bears the risk for the excess when the plan defaults if the company is insolvent. Moreover, the PBGC is underfunded (currently, its cumulative deficit is nearly $2 billion), leaving the possibility that even insured benefits might not be paid if the plan sponsor is insolvent. *See* Richard A. Ippolito, PENSION RESEARCH COUNCIL, THE ECONOMICS OF PENSION INSURANCE 41-43 (1989). In fact, some observers have identified the PBGC as the next likely candidate for a massive federal bailout. Its demise could cost taxpayers as much as $30 billion. *See* Grey Peril, ECONOMIST, May 11, 1991, at 78 (U.S. ed.).

32. Defined benefit plans are the dominant form of pension plan, but defined contribution plans have become increasingly popular with employers and with some classes of employees. Employers prefer them because they limit the employer's liability risk. Firms are especially eager these days to limit their health care liability risks. There is anecdotal evidence that some firms have tried to market these plans to their employees as a means by which employees can cover the risk of rising health care costs through their own contributions with pre-tax dollars, I.R.C. § 401(k) (1988). To be fair to employers, though, they are caught in a squeeze between rising health care costs and new accounting rules (developed by the Financial Accounting Standards Board ("FASB")) that require firms to list their liability for health care benefits on their balance sheets and, using double-entry accounting, their assets to cover this liability.

Different classes of employees may have different preferences about the type of plan offered. Younger, higher paid employees, who have more expendable income, likely prefer defined contribution plans. These plans allow them to benefit from the tax advantage (under I.R.C. § 401(k)) of augmenting employer contributions with their own contributions of pre-tax dollars. Retirees and older employees, on the other hand, prefer defined benefit plans because their preference at that stage is to consume, not to save.

they give their participants a false sense of security, as the asset reversion boom during the 1980s demonstrated.[33] In addition, through final pay arrangements, they backload benefits to a disturbing extent.

Defined contribution plans are more consistent with the democratic model of pensions than are defined benefit plans. They permit the beneficial owner to be more active—through his or her own contributions to 401(k) plans—in managing his or her own retirement funds. Moreover, by allocating the investment risk to the employee, who is, after all, the beneficial owner, defined contribution plans give the owner greater responsibility over his or her own life and over affairs that affect the community to which the owner belongs. In this respect, defined contribution plans are also more consistent with classical economic theory, which holds that risk and control should be concomitants of ownership. Return is the market's compensation for the owner's risk-taking, and to manage that risk, owners should have control.

A basic tension exists, however, between defined contribution plans and prevailing pension policy. The Employee Retirement Income Security Act's ("ERISA's") twin policies of passivity and paternalism seemingly require that employees not bear the investment risk. Consequently, the more paternalistic defined benefit plans are more consistent with fiduciary policy.[34] Allocating the investment risk to the employer justifies withholding investment control from employees. Although classical economic theory does not support owner passivity as to defined contribution plans, it does support fiduciary law's allocation of control to the employer as the risk-bearer for defined benefit plans.

Defined contribution plans are more compatible with the democratic model than are defined benefit plans in another sense. Because employers do not bear the investment risk (and are not required to pay for insurance against that risk) under defined contribution plans, theoretically they should be willing to contribute more to the pension fund, enabling either greater benefits, wider participation, or both. A pension system that more widely protects employees is more democratic than one that includes coverage gaps based on income levels, gender, and other forms of unjustified social hierarchy.

Most private pension plans are single-firm, or corporate plans, rather than multifirm plans. A corporate plan is one that a single employer firm sponsors for only its employees. Single-firm plans more commonly exist in heavily concentrated industries with a few dominant firms. Multifirm plans, where several firms contribute to a common plan, are more typical among industries in which employment patterns are irregular, such as the construction industry.

33. *See* Langbein & Wolk, *supra* note 6, at 647-48. The wave of asset reversion touched off a political controversy. Organized labor and its supporters tended to oppose the ability of employers to recapture plan assets. The Reagan administration, on the other hand, supported asset reversions, subject to a non-deductible 10% excise tax. *See* Norman P. Stein, *Taxing Reversions from Pension Plans*, 35 TAX NOTES 1131 (1987).

34. My point is not that defined contribution plans, which ERISA explicitly authorizes, squarely contradict fiduciary policy. Rather, the point is that defined benefit plans adhere to ERISA's twin policies of paternalism and passivity more completely than do defined contribution plans.

"Multis," as they are called, tend to be quite large. It is not uncommon for a multi to have 10,000 or more active participants.

Multis are created by collective bargaining agreements between unions and employers. Section 302 of the Taft-Hartley Act,[35] which regulates the structure of collectively bargained plans, including multifirm plans, requires that an equal number of union and employer representatives serve as plan trustees[36] to manage the plan assets. Considerable disagreement exists concerning whether this requirement of equal representation produces neutrality on trustee boards. The view from the political right is that many multiemployer plans are dominated by unions: "In the worst case, a management selected trustee for a multiemployer plan sponsored by a mobster dominated union risks labor trouble or worse if he defies the wishes of the union."[37] The view from the political left is that section 302 of the Taft-Hartley Act set the legislative precedent for removing control over the use of pension capital from unions and placing it in the hands of specialists within the private financial community, notably financial intermediary firms.[38]

The boards regulating jointly administered plans were not expected to make investment decisions themselves, delegating that responsibility instead to investment specialists. Moreover, equal union and management representation on collectively bargained plans was a compromise of the demands originally made by union leaders prior to enactment of the Taft-Hartley Act. As part of the struggle to improve workers' compensation after years of wage restrictions during World War II, union leaders in the coal industry demanded that employers contribute to a union pension fund managed entirely by the union.[39] In enacting the Taft-Hartley Act, Congress directly rejected this demand to ensure that labor did not control the enormous supply of capital that both sides realized was at stake in the creation of the pension economy.[40]

III
THE PENSION-FUND SOCIALISM THESIS

The pension-fund socialism thesis fails as an answer to a more participatory form of ownership. The pension-fund socialism thesis essentially claims that the

35. 29 U.S.C. § 186(c)(5) (1976).

36. Although § 302(c) of the Taft-Hartley Act refers to employer designated trustees as "the representatives of the employer," these persons are not agents of the employer but fiduciaries for plan participants and beneficiaries. *See* NLRB v. Amax Coal Co., 453 U.S. 322 (1981).

37. Fischel & Langbein, *supra* note 30, at 1135-36.

38. *See* Rifkin & Barber, *supra* note 20, at 101.

39. *See id.* at 99.

40. To a large extent, the fear of union controlled pension capital was aimed at the possibility that unions would use pension capital as a strike fund. Senator Robert Taft, co-author of the Taft-Hartley Act, for example, explicitly voiced that fear, stating, "Certainly unless we impose some restrictions, we shall find that the welfare fund will become merely a war chest for the particular union. . . . [In labor's hands] the whole thing could become a great weapon of power." 80 Cong. Rec. 78 (1947). This argument was a familiar red herring of the political right; common law fiduciary rules would have ruled out that possibility.

corporate pension system already is a privatized form of socialism. This thesis is mistaken at both ends. At one end, the corporate pension system is not thoroughly private. Major aspects of it are nonconsensual and paternalistic. At the other end, the pension system is not socialist in any nontrivial sense of the term. It does not extend the ideal of democratic participation either to the domain of employee-provided capital or to the workplace.

A. The "Publicness" of Private Pensions

Three distinguishing features are commonly attributed to the U.S. private pension system. The system is said to be employment-based, tax-encouraged, and consensual, that is, private.[41] There is little room for disputing that the corporate pension system is employment-based and tax-encouraged, but the description of corporate pensions as "consensual" is somewhat illusory. Contrary to the conventional understanding, the corporate pension system and the federal government's social security program do not constitute polar approaches to providing retirement benefits, one wholly private, the other public. It is more accurate to view corporate pensions as a hybrid program, combining public and private aspects. In this respect, corporate pensions are, like other important resources including land, privately owned but inherently social.

From both the employer's and the employee's perspective, the highly favorable treatment of pensions under federal tax laws[42] suggests that the government is not neutral about the employer's decision to offer, or the employee's decision to accept (to the extent employees have any choice) a pension plan as part of the compensation arrangement. The corporate pension plan system, although formally private, is a key component in government policies on retirement and other employee benefits, supplementing the federal social security system for a large percentage of the workforce.

More importantly, pensions involve a set of decisions over which employees usually have little control. The most significant of these is the decision to join the plan. According to the prevailing theory, pensions are a form of deferred compensation.[43] However, it is more accurate to describe them as a system of

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41. *See* Langbein & Wolk, *supra* note 6, at 24.

42. The principal tax advantages of pensions are the following: first, employers may, subject to certain limitations, deduct from their taxable income their contributions to the pension trust, I.R.C. §§ 404(a)(1), (2), (3); second, the pension trust (which is a taxable entity) is exempt from tax on its investment income, I.R.C. § 501(A); third, the employee (or other beneficiary) is subject to income taxation only when amounts are actually distributed to her rather than when the employer contributes to the plan; and fourth, employees increase their savings (for health insurance, child care, or other tax-exempt or tax-deferred fringe benefits) by saving with pre-tax dollars. I.R.C. §§ 404(a)(1)-(3), 501(A).

43. *See* Langbein & Wolk, *supra* note 6, at 15. This is the feature that most significantly distinguishes pensions from other employee benefits such as health care, life insurance, and disability plans. These benefits all represent employee-purchased services, rather than forms of deferred compensation. This is not to deny that such benefits are an important part of the wage-and-benefit package that employers offer to employees as compensation—they are. But they are not truly interchangeable with wages, either from the employer's or the employee's perspective. Employer pension contributions, on the other hand, represent compensation that the employer presumably would otherwise have paid as current wages to the employee. This distinction becomes important in explaining

compelled savings, loosely analogous to the nonconsensual social security system. Participating in a pension constitutes a compelled decision to forgo current consumption in favor of future consumption. Even in noncontributory plans, the employee whose job automatically makes him or her a participant in a corporate pension contributes to the plan in the form of reduced wage compensation.

In general, neoclassical economic theory predicts that, other things being equal, most people would rather receive the same amount of compensation as after-tax wages than as employment benefits.[44] Current cash compensation maximizes the employee's freedom to choose his or her own consumption pattern. The compulsory character of pensions thus raises familiar issues of collective paternalism.[45] Characterizing corporate pensions as a privatized form of paternalism would directly threaten the liberal ideal of individual owner autonomy, and undermine the argument that corporate pensions are a system of employee benefit entirely distinguishable from government welfare benefit programs, notably the social security program.

The basic reason why pensions deny employees the exit option is the judgment that "[l]eft to their own devices, many people will not save enough for their old age."[46] Temporally inconsistent preferences, preference changes due to adaptation to new circumstances, and simple myopia create a systematic pattern of consumption and savings behavior that sacrifices long-term self-interest to short-term individual satisfaction.[47]

This rationality gap creates good reasons for compelling individuals to participate in plans that bind them to saving for retirement security.[48] The restraint against opting out of a pension plan is a classic example of a precommitment device.[49] The employee accepts employer contributions to his or her pensions, rather than receiving the contribution in the form of higher wages, because the employee knows that he or she is weak-willed (a condition known in the rational choice literature as *akrasia*) or may become vulnerable to temporary financial pressures in the future, and would spend the additional income rather than saving it. Employees, that is, choose to sacrifice their short-term preference for higher income in favor of satisfying their long-term preference for economic security. From this perspective, pension participation enhances rather than encroaches upon individual autonomy.

This explanation overlooks the degree of employee choicelessness in the decision to save. The decision to forgo present consumption in favor of saving

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why the vision of participatory ownership does not extend to these employee benefits.

44. *See* Daniel S. Hamermesh & Albert Rees, The Economics of Work and Pay 341 (4th ed. 1988).

45. *See* Weiss, *supra* note 11, at 1279-85.

46. *Id.* at 1275.

47. The best systematic explorations of these problems in rational-choice theory are by Jon Elster. *See* Jon Elster, Sour Grapes: Studies in the Subversion of Rationality (1983); JON ELSTER, ULYSSES AND THE SIRENS: STUDIES IN RATIONALITY AND IRRATIONALITY (1979) [HEREINAFTER ULYSSES AND THE SIRENS].

48. *See generally* Elster, ULYSSES AND THE SIRENS, *supra* note 47.

49. On the role of precommitment devices generally, see *id.* at 36-111.

for retirement (or other benefits) typically is not made by the employee, but by the employer, either acting alone or, in unionized firms, together with a collective bargaining unit. The account of enforced savings as a precommitment device that respects individual owner preference depends, therefore, on a theory of imputed employee intent. It is possible that if employees were free to choose, they would opt for saving rather than increased income, but this is far from certain.[50] The important fact is that employees typically do not have the opportunity to choose. Consequently, one cannot categorically deny the paternalistic character of corporate pensions. The precommitment device rationale, moreover, does not require paternalism or passivity in all or even most internal aspects of the plan's governance. One might rationally conclude that although good paternalistic reasons exist for denying participants the opportunity to exit from the plan, participants should still have substantial voice in internal governance decisions. Indeed, as Hirschman's study powerfully demonstrated, a major reason for denying exit is that doing so tends to make the voice option more meaningful.

Even if corporate pensions are paternalistic, it is possible to defend them as such.[51] The insight here is that precommitment devices work only when the individual experiences *akrasia* and acts on his or her self-knowledge. Where individuals either lack that self-knowledge or cannot act on it because their weakness of will paralyzes them, others must act for them, as they would do if they possessed more complete self-knowledge or could act on it.

From the perspective of a political theory that emphasizes responsibility as do the civic and communitarian theories, the case for pensions as a form of paternalism is somewhat uneasy. The one step away from individual self-control that the pension system takes the precommitment device idea is substantial. It is unnecessary to defend it here because the immediate point is that to the extent that one views corporate pensions as paternalistic, one cannot categorically distinguish the nominally private pension system from more overtly public and paternalistic forms of social insurance.

B. Pensions as Unsocialist

The other half of the pension-fund socialism thesis is also false. The thesis trades on a superficial understanding of socialism. On the surface, pension funds do seem to represent a more socialized form of capital ownership than does

50. This seems most plausible with respect to employees who obtain significant tax advantages from contributing to pension plans with pre-tax dollars, people who tend to be higher income employees.

51. For such a defense, drawing on psychological literature empirically detailing the phenomenon of inconsistent preferences over time, see Weiss, *supra* note 11. This is not the appropriate occasion for reviewing all of the arguments sometimes offered to justify legal intervention in private preferences; see Cass Sunstein, *Legal Interference with Private Preferences*, 53 U. Chi. L. Rev. 1129 (1986) (presenting a useful summary and overview of the arguments based on pathologies of preference formation). But, to suggest just one available argument defending pensions as paternalistic, one could point out that even as a form of legal paternalism the pension system moves the precommitment device idea only one step further away from individual autonomy.

classical liberal ownership. Pensions deviate from the classical liberal form by disintegrating ownership and withholding control from the owner. The pension system breaks up property into distinct incidents, which it then vests in various actors. But this feature is also true of the corporate form generally, which separates beneficial ownership from control, and the traditional trust form, from which the corporate form developed. Corporate pensions merely extend the disaggregation principle by removing control over the decision whether to save from beneficial claimholders, and by removing capital management and investment control from the trustee. Thus, it cannot be said that disaggregation of ownership is a sufficient characteristic of socialist ownership.

The pension-fund socialism thesis truly focuses on the fact that pension funds, by pooling vast amounts of capital, now hold dominant ownership positions in all sectors of the economy. Workers indirectly own most of the investment capital—the means of production—in the U.S. economy. But this is social ownership of the means of production only in a formal sense. Classical socialism sought to vest ownership of the means of production in workers so that workers would control the use of capital. The crucial characteristic of socialism is its extension of democracy to the ownership of property. Unlike classical liberalism, it does not confine political ideals to the nominally public sphere, but considers those ideals relevant to the economy as well. More precisely, socialism requires that control over capital, not just the beneficial claims to capital, be socialized. This is exactly the characteristic that the corporate pension system lacks.

IV
FIDUCIARY LAW AND THE LEGAL CONSTRUCTION OF PASSIVE OWNERSHIP

The rise of the corporate pension system exacerbates an important paradox of capitalist development. As capitalist economies become more advanced, and therefore more successful, the owners of capital have less control over it. This attenuation of control from benefit undermines the basic political vision inherent in liberal property theory, individual autonomy secured through private ownership of property. In advanced capitalist societies, the individual owner becomes only a capital supplier. In making decisions for the individual, financial intermediaries assume a role loosely analogous to that of the state under state socialism.

To explain the distancing of owners from control of the capital, as capitalist economies become more advanced, Dean Robert Clark offers his theory of the natural evolution of capitalist institutions.[52] Dean Clark argues that the increasing division and concentration of discretionary control over capital in capital management and investment specialists reflects the efficiency advantages of role specialization, and the awareness of these advantages by key individuals who are responsible for creating institutions like corporate pensions. According to this thesis, law plays only a responsive role, developing different regulatory

52. *See* Robert Clark, *The Four Stages of Capitalism*, 94 Harv. L. Rev. 561, 568-69 (1981).

strategies that seem appropriate to the peculiar problems that novel nonlegal institutions emerging with each successive stage of capitalist development pose.

The evolution theory fails to acknowledge the creative role of fiduciary law in explaining the increasingly nonparticipatory character of capital ownership. Fiduciary law structures the relationship between beneficial owners of pension capital and pension managers, not simply as a response to efficiency problems that new forms of financial intermediation create, but according to a social and political vision of capital ownership as passive. Specifically, fiduciary law assumes that the appropriate role of pension owners is that of passive investors, rather than self-governing and responsible owners. Consequently, fiduciary law constructs a pension governance structure designed to inhibit participation by equitable owners.

A. Pension Management Structure

Pension fiduciary law reduces pension owners to passive investors through its preference for highly fragmented pension fund management. In this respect ERISA deviates from trust law. Common law trusts have only one fiduciary role, the trusteeship, and it is rare to have more than three persons (including corporate fiduciaries) simultaneously acting as trustees. Since trust law consolidates all fiduciary powers, including investment powers, in the hands of a few trustees, or even only one, it is relatively easier for trust beneficiaries to monitor trustee behavior than it is for shareholders to monitor corporate managers. To be sure, trust law, like corporate law, envisions that beneficial owners usually will adopt a passive role, but when trust beneficiaries do wish to exercise greater responsibility by monitoring trustee decisionmaking, they do not confront the multi-tiered decisional hierarchy that shareholders typically do.

Unlike trust law, ERISA invites fragmentation of the fiduciary office. Each plan has at least one, but more typically several trustees. Plan trustees are subject to the direction of a fiduciary that is an ERISA innovation, the "named fiduciary," who has "authority to control and manage the operation and administration of the plan."[53] The statute vests the power to select the named fiduciary in the sponsoring employer.[54] Beneficial owners have no control over the named fiduciary, and no opportunity to participate in the selection of the named fiduciary. In this respect, pension participants have less input than corporate shareholders, who, at least in theory, elect the board of directors.

A second way in which ERISA deviates from the common law trust model to further attenuate beneficiaries from control of pension capital is that it strips the pension trustee office of the investment function. Pension plans almost invariably take advantage of the statutory authority to delegate decisions concerning the acquisition, management, and disposition of plan assets to yet

53. ERISA § 402(a)(1), 29 U.S.C. § 1102(a) (1989).
54. *Id.* § 402(a)(2), 29 U.S.C. § 1102(a)(2).

another statutory creature, an "investment manager."[55] ERISA creates a strong incentive for pension trustees to delegate investment decisions to investment managers by relieving the trustee of liability for mismanagement of plan assets turned over to managers.[56]

Some firms exacerbate pension ownership passivity by keeping all of these fiduciary positions at home, appointing in-house trustees, named fiduciaries, and investment managers. In effect, ERISA allocates ultimate control of pension assets to the employer's officers. The law gives pension beneficiaries no right directly to participate in decisions about the use of pension assets.[57] Neither does pension law give beneficial owners indirect voice, such as by recognizing a right to participate in decisions about the selection of persons who control pension assets.

Much more commonly, however, firms use several different outside specialists, portfolio managers, and other investment professionals, to carry out the various fiduciary roles. This is especially true with respect to asset management and investment. Investment professionals handle the great bulk of pension capital. The largest plans divide their pension capital among dozens of capital management firms. These professionals, not the plan trustees or the beneficiaries, have the real responsibility for controlling the use of pension property.

B. The Paternalistic Construction of the Fiduciary Office

Another important legal factor that reduces pension participants to a passive role is pension law's construction of the fiduciary office as paternalistic. As previously noted,[58] ERISA's paternalistic policy on whether to allow employees the opportunity to opt out of participation in a pension plan does not necessarily justify paternalism with respect to internal governance issues. ERISA constructs the fiduciary office in a way that concentrates control over internal matters exclusively in the trustee and other pension fiduciaries. But participants do not need trustee protection on some internal issues. On many of these issues, participants do not act alone, but act through a group, most notably a union. If

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55. *Id.* § 402(c)(3), 29 U.S.C. § 1102(c)(3).

56. *Id.* § 405(d)(1), 29 U.S.C. § 1105(d)(1).

57. It might be argued that participants of well-funded defined benefit plans should be indifferent about their nonparticipation in investment decisions, since the firm bears the investment risk and, so long as the plan is adequately funded, the participants' economic interest is not threatened if the investment managers make evenly wildly imprudent decisions. *See* John H. Langbein, *The Conundrum of Fiduciary Investing under ERISA, in* Pension Research Council, Proxy Voting of Pension Plan Equity Securities 128, 131-33 (Dan M. McGill ed., 1989). This point is correct, but it does not completely answer the objection. First, as I noted earlier, employers increasingly prefer defined contribution plans, under which the participants do bear the investment risk. Second, while most plans currently still are defined benefit, underfunding is a major problem. Corporate pensions are federally insured by the PBGC in the event the sponsoring firm defaults, but the status of the PBGC's fund itself is uncertain. *See supra* note 31. Third, there are reasons for giving voice to plan owners over investment decisions apart from protection of their investment stakes.

58. *See supra* text accompanying note 10.

the union itself is democratically structured, the participant can exercise voice through collective action and therefore obviate the need for trustee protection.

An obvious example of ERISA's paternalism is its anti-alienation rule.[59] This rule provides that participants may not assign their interests, nor may their creditors attach their pension interests.[60] The rule's purpose is to guarantee that pensions are used for retirement income by preventing participants from consuming their interests prior to retirement.[61]

The model for the rule is the so-called spendthrift trust recognized in private trust law. There is an important difference, however. Spendthrift trust restraints are not mandatory; they are imposed only by the settlor. Under ERISA, the alienation restraint is compulsory;[62] the participant, who occupies the roles of both beneficiary and creator,[63] has no control over this term.

Apropos of governance issues, a more important example of ERISA's paternalistic approach to the fiduciary office concerns the trustee's exclusive control over investments. Participants cannot direct the trustees to limit their investments to particular industries or geographic areas. ERISA requires the trustees to act for the exclusive benefit of the participants. The meaning of "benefit" is limited to maximizing returns to the fund. The upshot of this definition is that trustees are forbidden to consider noneconomic considerations, such as promoting employment in the geographic area, encouraging unionization, or saving the jobs of plan participants,[64] even if the plan participants express their approval of such factors.[65] Paternalism is especially inappropriate here because a conflict of interest is likely to exist between current employees and retirees. In this context, paternalism is incompatible with the trustee's fiduciary obligation to act impartially, a corollary of the exclusive benefit rule.[66] An approach that would allow trustees to be guided by a vote of all the participants

59. ERISA § 206(d)(1). The Internal Revenue Code provides the same rule as a condition for tax qualification. *See* I.R.C. § 401(a)(13)(A).

60. There is an exception for domestic relations creditors, as in private trust law. *See* ERISA § 206(d)(3)(A), 29 U.S.C. § 1102(c) (1989).

61. ERISA does allow loans to participants and beneficiaries. *See id.* § 408(b)(1), 29 U.S.C. § 1102(a) (1989).

62. Again, it is compulsory in the sense that it is a condition for tax benefits. While it is true that the plan participants can alienate all they want if they or their employer is indifferent to tax consequences, tax indifference is not widely apparent in this context.

63. This is the central insight of Fischel and Langbein's important article. *See* Fischel & Langbein, *supra* note 30, at 1105.

64. *See* Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully under ERISA?*, 31 Lab. L.J. 387, 389 (1980). A notable case deviating from this view is Donovan v. Walton, 609 F. Supp. 1221 (S.D. Fla. 1985), *aff'd per curiam sub. nom.* Brock v. Walton, 794 F.2d 586 (11th Cir. 1986).

65. *See infra* notes 81-83.

66. ERISA lacks an express analog of trust law's duty of impartiality. Trust law derives that duty, however, from the logic of its duty of loyalty, the direct analog to ERISA's exclusive benefit rule. It seems likely, then, that courts will interpret ERISA to impose an impartiality duty. One possibility is to interpret the anti-discrimination norm to create such a duty. *See* Fischel & Langbein, *supra* note 30, at 1159-60.

would add an important measure of democracy to pensions without unduly jeopardizing the fiduciary office.[67]

C. Voting and Other Control Rights

A third legal factor that has caused passivity in equitable pension ownership concerns the exercise of voting rights in, and other forms of control over, corporate stock held as a plan asset. Under defined benefit plans, the trustee or the investment manager, not the participant-owners, exercises the right to vote stock in matters such as election of corporate directors and auditors,[68] and organic corporate changes, including mergers, stock exchanges, and asset sales. Plan fiduciaries hold and vote the shareholders' proxies.[69] Voting proxies is a fiduciary act, as to which trustees have a duty to act for the exclusive benefit of plan participants. However, this does not require them to consult with the participants.

Another facet of pension ownership that deprives participants of control rights is the tender of plan stock in a hostile takeover. Where the sponsoring firm is the target of a takeover, and the plan includes substantial holdings in that firm's stock, management has strong incentives to reject the tender offer. The question is whether the plan's trustees, who are either selected by management or are the managers themselves, can refuse the offer consistently with their fiduciary duty to act solely in the participants' best economic interest and to refrain from any action that does not maximize plan benefits.[70] Moreover, as mentioned above,[71] ERISA's "prudent investor" rule defines "benefit" exclusively in terms of economic protection of the participants' plan investment. In the takeover context, the offering price usually includes a significant premium,[72] so that the policy of maximizing the participants' retirement interests seems to require that the trustees accept the offer. But legal challenges to rejections of the offers more frequently have been brought by the Department

67. If the trustees themselves decided to invest plan funds to save the employees' jobs, they would open themselves to the charge that they breached their duty of impartiality by effectively transferring wealth from retirees and older employee participants to younger employee participants. An example of such an action was the Teachers Retirement System's decision to purchase over $2.5 billion in municipal bonds from New York City at a time when the city was on the brink of bankruptcy. In Withers v. Teachers Retirement System, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979), the court approved the trustees' actions under common law trust principles (ERISA does not apply to public pensions). For a criticism of this decision, see Fischel & Langbein, *supra* note 30, at 1144-46.

68. Shareholders typically do not directly elect auditors, as they do directors. Rather, they are asked in proxy solicitation materials to approve management's appointment of a particular auditing firm.

69. With the waning of hostile takeovers, pensions increasingly may look to proxy fights as a means of expressing dissatisfaction with management. *See* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 Colum. L. Rev. 1931, 1932-33 (1991).

70. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A)(1980). The "exclusive purpose" rule of ERISA requires that the trustee act for the exclusive purpose of benefitting the participants and refrain from any action that does not maximize plan benefits.

71. *Id.* § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i)(1980). *See supra* text accompanying note 64.

72. Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982). In the LTV/Grumman takeover fight, the offering price was nearly double the pre-offer price.

of Labor, which has regulatory authority under ERISA, rather than plan participants. Typically, employees' interests align with those of management in this situation; neither wants the takeover to succeed for fear of job loss, wage cuts, or both. From this perspective, it is pointless to give participants control over the trustees' action. However, plan participants may have conflicting interests, and some, especially retirees under defined benefit plans, will have strong incentives to accept the offer.[73]

Following the much-noted Martin-Marietta/Bendix takeover battle in 1982,[74] most individual account plans, including ESOPs, now provide that the right to tender shares in a takeover situation rests with the individual participants and that a trustee can tender shares allocated to individual participants only if the participants specifically direct the trustee to do so. However, the Department of Labor has taken the position that the fiduciary provisions of ERISA[75] prohibit "pass-through," that is, direct participant, voting as to unallocated shares in leveraged ESOPs. Further, as to allocated shares where the plan does provide pass-through voting, the trustee must disregard a participant's instructions where the trustee deems those instructions contrary to the participant's investment interest.[76] This interpretation strengthens the paternalistic cast of ERISA.

Diversified plans are not designed to promote employee democracy, so it is not surprising that fiduciary law gives participants in such plans little control over trustees. Remarkably, however, this picture is not significantly different for ESOPs and non-ESOP employer security plans, which are nominally intended to create a greater degree of employee democracy. ESOP tax legislation reflects a paternalistic bias similar to that of ERISA. It requires that ESOP plan participants be given the right to direct the plan as to the voting of the employer firm's securities that are voting shares and are allocated to the participant's individual account ("pass-through" voting).[77] In the case of employers that are publicly held corporations, the power to direct voting applies to any matter on which the securities are entitled to vote.[78] Incredibly, though, as to privately held employers,[79] the statute limits mandatory pass-through voting to approval or disapproval of "major changes," that is, corporate mergers, recapitalizations, liquidations, or dissolutions, or sales of substantially all of the assets of the trade

73. Defined contribution plans avoid this conflict between retirees and current employees by liquidating the participant's interest at the time of retirement.

74. The case is discussed in Edward A. Landry, *Fiduciary Responsibility under ERISA in a Takeover Situation*, 12 Prob. Notes 148, 151-52 (1986).

75. *See* ERISA §§ 403(a), 404(a)(1)(D), 29 U.S.C. §§ 1103(a), 1104(a)(1)(D).

76. U.S. Dep't of Labor, Opinion Letter on Tender Offers (Polariod), 16 Pens. Rep. (BNA) 390 (Feb. 23, 1989); U.S. Dep't of Labor, Letter on Proxy Voting by Plan Fiduciaries (Avon Products), 15 Pens. Rep. (BNA) 391 (Feb. 23, 1988). *See* Landry, *supra* note 74, at 151-52.

77. I.R.C. § 409(e) (1990).

78. *Id.* § 409(e)(3). It is also important to note that a substantial portion of stock held by ESOPs is nonvoting stock. *See* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 Yale L.J. 1749, 1797 (1990). As of 1990, for publicly held firms, however, employees must have voting power on all allocated stock in leveraged ESOPs. I.R.C. § 133(a)(6)-(7) (West. Supp. 1991).

79. Roughly 90% of all ESOPs are in privately held firms. Hansmann, *supra* note 78, at 1798.

or business.[80] The greater ramification is that in such plans the trustees can withhold from plan participants the power to direct voting of employer shares on such issues as election of the firm's directors.

A countervailing consideration concerning voting rights is that in employee-owned firms and firms whose plans own significant employer securities, individual voting may lead to results that are contrary to the employees' best interests as a group. Conflict of interests among participants is an important problem in most pensions,[81] and these different subgroups, voting their own interests, may vote in different ways if individual voting is permitted. The employees' best interests might be served by block voting, which does not dilute their voting power, particularly if outside shareholders or management have substantial holdings in the firm. Voting trusts have been used in some ESOPs as a response to this problem of vote dilution, but it is not clear whether courts will interpret ERISA to permit this practice.

Perhaps even more significant than the limited degree of control that ESOP plans confer on participants is the fact that employees typically lack control over the creation and termination of ESOPs. Unless the firm is unionized, the employer can create a plan without employee participation, either in the decision to create or to set the terms of plan. Moreover, even where there is employee participation in an ESOP's creation, ESOPs frequently are created, particularly among large publicly held firms, as a defensive tactic against takeovers because of the resulting alignment of management and employee interests. Both groups fear that takeover will mean job losses or wage cuts. Ironically, although employees cooperate in protecting managers from external discipline through the market for corporate control, the plans do not give the employees of a firm whose hostile takeover was prevented by creation of an ESOP the power themselves to discipline management. Indeed, the ESOP's success in defending the takeover itself may lead the now more entrenched management to conduct the very job cuts, wage cuts, or both that drove the employees to agree to the creation of the ESOP in the first place.

The reality of ESOPs and employer security plans, then, is that they are not employee-controlled. The most control that employee-participants, as equitable owners of the firm, can have in the firm's management is to elect directors and approve major changes involving the firm's capital structure. They lack voice as to all other basic policy issues, including investment and marketing strategy, and labor policies. As Fischel and Langbein correctly note, "The ESOP is best understood as a tool of corporate finance."[82] A genuinely democratic and participatory form of employee ownership would confer control over these matters to the participants.

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80. I.R.C. § 409(e)(3).

81. These conflicts include younger versus older employees, current workers versus retirees, and high-income versus low-income employees.

82. Fischel & Langbein, *supra* note 30, at 1155.

V
PROPERTY AND RESPONSIBILITY

This part critiques pension law's model of passive ownership from a perspective that links different forms of property ownership with moral and political personality. The basic claim is that pension law's model of beneficial ownership blunts development of an individual's sense of civic responsibility precisely because its purpose and effect are to remove the ideal of self-governance from large areas of social life. As a regulative ideal, the model of active, participatory ownership is preferable because it contributes to the fostering of personal and civic responsibility in individuals. Practical problems, however, do limit the extent to which participatory ownership can prudently be realized. Part VI examines several of these constraints.

A. The Role of Property in Developing Responsibility

Individual ownership of property creates the potential for individuals to practice personal responsibility and self-governance, which, in turn, can foster a sense of civic responsibility.[83] Realizing that potential, however, requires a particular form of individual ownership. It requires that individual owners have substantial and meaningful control over the use of their assets. A sense of responsibility develops only when a person has the opportunity to act responsibly. Having the opportunity to act responsibly means that one is empowered to make decisions and to practice self-governance. Responsibility, in short, requires activity. When an individual is denied the power to participate in those decisions that affect his or her life, he or she cannot feel committed. To live a passive life, that is, a life in which one is only a receiver, rather than a creator, is to experience dependency and degradation. Commitment requires individual empowerment, a sense of a measure of control over those decisions that affect the individual.

As the central and eastern Europeans who have emerged from their half-century-long nightmare can well attest, the lack of self-governance is precisely what is wrong with a regime based entirely on legal paternalism. The theory of state socialism, that all citizens were owners of the means of production and were represented by the state, mocked their real experience. Under state socialism, as it was practiced in Europe, the individual was relegated to the role of a passive receiver of whatever few benefits the state chose (and could afford) to pass along.

83. Jeremy Waldron has sketched an argument that largely, though not exclusively, coincides with this tradition. According to his argument, individuals are more apt to act responsibly and to develop a sense of enduring commitment to others under circumstances in which their subsistence depends on ownership of private property over which they have sole responsibility. Being responsible is to act intentionally with an "essentially future-oriented" perspective. The conception of individual freedom on which this argument trades is positive, not the classical liberal conception. *See* Jeremy Waldron, The Right to Private Property 310-13 (1988).

This vision of active ownership is antagonistic to certain forms of fragmented ownership. It is crucial that the owner be given the obligations along with the benefits of ownership. Thus, to pick a clear example from U.S. law, the responsibility perspective objects to spendthrift trust restrictions on trust beneficiaries' interests. These restrictions discourage responsibility by guaranteeing that the beneficiary continues to receive a stream of income for his life, regardless of how profligate are the beneficiary's ways.[84]

So long as virtually all property was owned according to the classical liberal mode of ownership, there was little occasion to worry about the relationship between specific forms of private ownership and responsibility. Private ownership was highly (though certainly not completely) individualized, and individuated ownership facilitated a sense of responsibility. It is only as new modes of private ownership, in which the traditional "bundle of rights" is disaggregated and the authority to manage property is spun off ownership, have been developed that the link between private ownership and responsibility has deteriorated. The emergence of the corporate pension system is only the latest stage in a long process of disaggregating individual ownership and weakening the connection between property ownership and responsibility. Berle and Means's classic discussion of the separation of ownership and control, although not focused explicitly on the question of responsibility, brought to the fore the extent to which passive ownership of corporate equity departed from the classical form of individual ownership.[85]

B. Delimiting the Scope of Active Ownership: Why Participation in Pension Ownership?

No one would suggest that individuals should actively control all aspects of their lives. It is reasonable to ask, then, whether an active, participatory form of ownership is at all appropriate in the workplace, and specifically in the management of pensions. Most people are happy to delegate decisionmaking responsibility to others in some areas of their lives. Health care, for example, has traditionally been characterized by a high degree of paternalism, although a more participatory model of the doctor-patient relationship has gained force in recent years. Still, few people are prepared to accept full responsibility for decisions regarding their health.

It is more useful to draw a comparison between pensions and private trusts. The fiduciary model of equitable pension ownership is directly based on trust law. ERISA requires that pension assets be held in trust,[86] and the trust form

84. For a particularly clear example of a statement to this effect, see John Chipman Gray, Restraints on the Alienation of Property viii-ix (2d ed. 1895). I discuss the ideology of Gray's argument in Gregory S. Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 STAN. L. REV. 1189, 1228-40 (1985).

85. *See* Cooke, *supra* note 4.

86. ERISA § 403, 29 U.S.C. § 1104.

was adapted to shape employee benefit plans well before ERISA.[87] If government largesse constitutes "the new property,"[88] pensions constitute "the new trusts."

Trust law imposes stringent non-waivable duties on trustees. Implicit in these rules is the assumption that trust beneficiaries are passive. Strict mandatory rules are needed to regulate trustee behavior because beneficiaries cannot be relied upon to monitor trustees.[89] In opposition, it could be assumed that passivity would not prevail among trust beneficiaries as commonly as it does among corporate shareholders because the typical private trust has many fewer beneficiaries than the corporation has shareholders. Moreover, information costs and collective action impediments to participation by beneficial owners are much lower in the private trust context, where beneficiaries usually do monitor trustee actions.[90] From this point of view, it would seem that the strict trust rules that create equitable trust ownership as passive are not needed.

What explains the existence of trust law's approach to regulating fiduciary behavior is the fact that, at least when the rules were developed, the assumption that beneficiary passivity and the need for fiduciary protection were the primary purposes for creating the trust was, by and large, correct. Most trusts were created to benefit individuals (usually family members, especially the settlor's wife, children, and future generations of descendants) who were socially constructed as dependent and passive. Most settlors had a paternalistic motive for creating their trusts: it was a surrogate for the settlor's personal protection of the beneficiaries, at least with respect to their economic interests.[91] The trust itself took the place of the settlor as an actively governing patriarch.

Modern pension law transplants the trust law assumption of beneficiary passivity to a quite different context. In one sense this assumption seems more well founded in the pension context than it did in the traditional trust context of the family. There are many more participants in the typical pension plan than there are beneficiaries in most private trusts, making the collective action impediment to participation far more acute than it is in the trust context.[92] In this respect, pensions are more analogous to corporations than they are to

87. In 1947, the Taft-Hartley Act required that multiemployer plans take the form of a trust (Labor Management Relations Act § 302(c)(5), 29 U.S.C. § 204), and since 1921, the Internal Revenue Service has conditioned qualification of a pension plan for tax benefits on use of the trust form. The present provision is I.R.C. § 401(a).

88. *See* Charles Reich, *The New Property*, 73 Yale L.J. 733 (1964).

89. Though compulsory, trust duties can be understood as compatible with a contractual approach to the problem of regulating trustees. The duties to invest trust property as the hypothetical reasonable trustee would do, to avoid favoritism toward any particular subclass of beneficiaries, and, above all, to act with undivided loyalty to the beneficiaries are all designed to simulate terms that rational beneficiaries and trustees would agree on if they actually negotiated the trustee's duties. The terms work to the mutual advantage of all beneficiaries and the trustee.

90. I ignore here the problem of unborn and unascertained trust beneficiaries.

91. *See* Alexander, *supra* note 84.

92. *See infra* part VI.B.

private trusts. Since the assumption of passivity has seemed justified in the corporate setting,[93] no one has really questioned its relevance to pensions.

There are several reasons to reject passivity in the pension context, however, even if one accepts it as valid in other contexts. The economic and workplace spheres are not analogous to the family. Creating a meaningful opportunity for pension participants to exercise voice fastens pensions to the broader goal of infusing the principles of democracy in the economy and the workplace.[94] The goals of economic and workplace democracy are founded on the commitment to protecting employees and their communities from the multiple insecurities of the market, especially in the late capitalist environment of deindustrialization and deregulation.[95] Workplace democracy would indirectly protect employees from the dislocations of plant closing, job relocation, and wage reduction that these phenomena have caused, by giving employees a meaningful role in the decisions that directly affect their lives. Workplace democracy reflects the pragmatic judgment that employee participation best responds to the justified concerns of employees and the communities to which they belong (that is, for greater job security and investment stability) without unduly inhibiting the ability of firms to respond flexibly to changing market conditions.[96]

Pensions potentially could contribute to the realization of the vision of greater democracy in the workplace by giving capital ownership a directly participatory role in the investment process. Pensions could use their huge capital accumulations to affect firms' decisions, which directly affect their employees' lives, by investing a substantial portion of the plan's assets in stock of the sponsoring firm. Fiduciary law, however, constrains most pension plans from realizing that potential. Workplace democracy requires a more active form of pension participant ownership; it requires that employees, as the owners of pension capital, possess the legal and actual power to exercise control over its use. Fiduciary law constrains most pensions from gaining economic leverage in

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93. *But see* Bernard Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990).

94. This is not to say, though, that employees should be given voice in every arrangement that is in any way work connected. It may not be appropriate to extend the participatory model of ownership certain employment benefits such as health care and life insurance. For reasons that I have already indicated, the voice model seems most appropriate with respect to defined contribution plans rather than defined benefit plans. *See supra* note 32. Employment benefits like health care and life insurance seem more analogous to defined benefit plans. Unlike defined contribution pension plans, health care and life insurance benefits are typically well defined, especially in the collective sense that there is relatively little uncertainty over what the employee's benefits are. This contrasts with defined contribution pensions in which what goes in is well defined but what comes out is less certain.

95. On the potential of pensions as a vehicle for implementing a more democratic vision of capital ownership, see William H. Simon, *The Prospects of Pension Fund Socialism* (1991) (unpublished manuscript, on file with author); William H. Simon, *Social-Republican Property*, 38 UCLA L. Rev. 1335, 1380-82 (1991). On the potential role of labor law in implementing this vision, see Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73 (1988) [hereinafter *Labor and the Corporate Structure*]; Katherine Van Wezel Stone, *The Legacy of Industrial Pluralism: The Tension between Individual Employment Rights and the New Deal Collective Bargaining System*, 59 U. CHI. L. REV. 575 (1992).

96. *See* William H. Simon, *Contract versus Politics in Corporation Doctrine*, *in* David Kairys, The Politics of Law 387, 404 (1990).

their sponsoring firms, among other ways, by imposing a diversification requirement. ESOPs, of course, do focus their investments in the sponsoring firm's stock, but even here workplace democracy has not been significantly advanced. Most ESOP plans do not involve substantial worker control. Instead, they adhere to the passive model of ownership. Nevertheless, ESOPs do represent at least nominal endorsement of the ideals of democracy in the employment sphere and employee self-governance.

VI
CONSTRAINTS ON INTERNAL PENSION VOICE

Assuming that, in principle, increased employee participation and responsibility is normatively desirable, is it practical to look to pensions as a potential locus for creating a more democratic form of ownership? Three factors might be cited to indicate why a highly participatory pension system is neither feasible nor ultimately desirable: lack of investment expertise; apathy; and diversification of employees' investments to avoid undue risk-taking. All three reasons relate to employee control of both their capital and the workplace (Models One and Two), but the concern with diversification seems more strongly to affect the model of employee control over the workplace (Model Two).

A. Specialization and Investment Expertise

One problem with giving pension participants greater control in their internal governance, including investment decisions, is that they lack the necessary expertise. This point justifies the passive model of ownership insofar as it protects the beneficiaries' economic stakes better than would the democratic model of pensions. Investment is a highly specialized activity, and few employees have the expertise or the inclination to devote the resources necessary to participate actively in pension investment decisions. With respect to whether the employer or the employee should have the power to select and control investment specialists, the employer may be said to be in the better position to select and monitor third-party specialists.[97]

It is sometimes thought that the efficient capital market hypothesis ("ECMH") diminishes the importance of investment expertise. In fact, this is not so; the ECMH simply changes the sorts of expertise an investment specialist must possess. The ECMH holds that a sound investment strategy is to invest the equity portion of a portfolio in index funds, which are designed to match market performance, and leave it there. Selective investing increases transaction costs and, in the overwhelming number of cases, results in performance inferior to that of the market. The ECMH strategy does not eliminate the need for investment expertise, though. Instead of the ability to pick particular stocks that are undervalued, investment advisers must be able to assemble diversified portfolios,

97. *See, e.g.*, Langbein & Wolk, *supra* note 6, at 30.

and to hedge investment risks using sophisticated dynamic hedging strategies such as index arbitrage.

The decisional structure that ERISA creates may, at times, economically disadvantage beneficial owners. Investment managers, who owe their positions and remuneration to the firm's officers, have strong incentives to invest in ways that are calculated to win the approval of the firm's top managers. The theory of virtual representation does not answer the concern about whether investment decisions satisfy the beneficial owners. Corporate managers do not always share the same objectives as the beneficial owners, so that rent-seeking behavior by outside investment specialists may work to the detriment of the owners.

Specialization is largely illusory in some contexts, however. Defined contribution plans are usually considered riskier for employees than are defined benefit plans, because the employee bears the investment risk and the plan is not federally insured.[98] Despite the fact that the employee bears the investment risk, the employer often controls investment decisions. Large firms typically hire investment specialists or let employees choose among several mutual funds. In small firms, however, where defined contribution plans greatly outnumber defined benefit plans,[99] the owner commonly manages the pension fund.[100] Small business owners may not possess greater expertise about managing portfolio risk than do their employees, or have any knowledge about their fiduciary obligations.

A related problem is that small business owners may be tempted to use pension funds to bail out their failing business, or as a source of needed capital for their own enterprises. Even if the owner is expert in managing risk and is aware that such uses of pension funds breaches her fiduciary duties, that knowledge may not deter the owner from misuse.

B. Apathy

A more serious impediment to both models of democratic pension ownership is the familiar problem of rational apathy. The collective action problems that are widely thought to make shareholder voice ineffectual in the corporate setting apply in the pension setting as well.

The stock explanation of why shareholder voice fails as an effective response to the agency problems associated with the separation of management and equitable ownership asserts that shareholder passivity is inevitable. Even where they are given voice (that is, legal power to control managers or to participate in decisionmaking processes through proxy rules), shareholders rationally conclude that it is not worth their time and effort to exercise the voice option. The problem is not that these beneficial owners do not value participation at all.

98. As I have already indicated, however, this advantage of defined benefit plans has to some extent been exaggerated. *See supra* text accompanying note 31.

99. *See* Charles Slater, *Retirement Plans that Quietly Melt Away*, Wall St. J., June 6, 1991, at C1, col. 3.

100. *Id.*

Rather, it is that the costs of participation exceed the benefit to them individually. Participation is not costless, and participation costs are especially high if there are many other investors in the firm. The plan participant owns only a small fraction of any single firm's stock, so the gains to the individual investor's holdings in the firm from participation usually do not justify these costs.

Collectively, the value of multiple beneficial owners having similar interests may well be high enough to justify active participation, but collective action efforts to capture these potential gains face coordination obstacles. Collective action is also not costless, and its benefits are nonexclusive. Consequently, individuals have incentives to free-ride off the efforts of others. Because all of them share this incentive, the result is that no one makes an effort to participate in decisionmaking. So, passive ownership is not the contingent result of legal rules, but the result of the logic of rationality.[101]

This story is used to explain both why institutional investors such as pension funds rarely attempt to influence corporate policy and why, within pension funds themselves, individual plan participants are apathetic about the use of the plan's capital. Part of the reason for apathy in both situations—by pension plans as shareholders and by participants within individual pensions—is dispersion of ownership. Most pension plans do not own large stakes in any single firm. Rather, pension portfolio managers invest the plan's capital in a variety of assets, representing both equity and debt of a large number of firms. Because they lack significant control over any single firm, pension plans as institutional shareholders lack incentives to participate actively in any firm's affairs. Similarly, individual participants have little reason to invest resources in monitoring the plan fiduciaries. Pension participants and shareholders obviously differ with respect to the percentage of the entire portfolios that the investment represents. The individual pension participant's stake in a pension fund usually is not small in relation to his or her overall portfolio, while the shareholder's investment in any single firm rarely constitutes a substantial portion of the shareholder's entire portfolio. Pensioners own interests in only one fund, while stockholders usually own shares in many firms. For many people, their pension constitutes the second or third largest single asset in their entire estate, after the family residence and life insurance. Pensioners have greater reasons to care, then, about the fund's management than most shareholders do about the management decisions of any single firm. Moreover, it is easier for participants to monitor plan managers than

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101. The locus classicus on collective action problems, of course, is Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Goods (2d ed. 1971).

Bernard Black has recently published a remarkable critique of this thesis, which he calls the "passivity story." *See* Black, *supra* note 93. His article discusses the phenomenon of passivity by pensions as institutional shareholders. Despite their enormous holdings of corporate equity, pensions historically have played little role in corporate governance decisions. (This phenomenon might be called the external aspect of pension passivity, to be distinguished from internal pension passivity, that is, voicelessness by participants of the internal management of pensions.) Black persuasively argues that this passivity might not be the inevitable result of collective action problems, but the contingent effect of legal rules that strongly inhibit institutional shareholders from being more active in corporate decisionmaking.

it is for shareholders to monitor the firms in which they invest. Unlike shareholders, they have only one fund to monitor, and can concentrate their efforts, rather than deciding which of several firms to monitor.[102]

Nevertheless, participants lack incentives to participate actively in the management of the fund, even if they had the legal power to do so. This is especially obvious in the case of highly diversified plans, which are analogous to mutual funds. The experience of diversified plans that have beneficiary-elected trustees (for example, TIAA-CREF) tends to confirm this prediction. Voter participation rates are low, and candidates rarely run on substantive platforms. At a minimum, then, increasing pensioner participation requires that plan assets not be highly diversified.

Nondiversification is a necessary but not a sufficient condition of overcoming apathy. Even assuming that nondiversification were legally and practically acceptable,[103] it would not be enough to make the democratic model of pensions a reality. This is because each participant's equitable ownership of the fund constitutes only a small fraction of the plan's total fund, so that his or her efforts are unlikely to have much effect. To offset that problem, plans would have to target their investments on institutions that most affect the participants. Creating conditions that would increase the incentives for participants to exercise voice requires concentration of ownership. Just as pensions might become more active shareholders if they owned larger stakes in single firms, so plan participants might take a greater interest in the governance of their pensions if the plan's capital were concentrated, and control was decentralized among the participants, rather than, as it is now, centralized in the fiduciaries. This points toward pension funds that are heavily invested in the workplace. ESOPs and other worker-owned enterprises meet this requirement, but, as this article has already indicated,[104] one should not look to ESOPs as the vanguard of pension or, more broadly, economic democracy. The so-called wage earner funds that exist in Sweden and Germany provide a more promising model for using pensions as a vehicle for redistributing wealth, but these plans are not designed to enhance pension democracy as such.[105]

As already noted above, collective action theory appears to suggest that apathy is a more serious problem for large diversified plans. This is not necessarily the case, however. A pension plan can be limited to union members, and block voting on important issues, including selection of plan trustees, can become part of the internal political life of a union. To some extent, this

102. A countervailing consideration, however, is that economies of scale may make it easier for some shareholders, especially institutional investors, to monitor multiple firms. *See* Black, *supra* note 93, at 589.

103. Nondiversification raises serious risks to the participants' economic security. A fundamental problem, then, that the democratic model of pensions faces is a trade-off between voice and diversification. *See infra* part VI.C.

104. *See supra* text accompanying notes 95-96.

105. On the wage earner funds, see Peter Swenson, Fair Shares: Unions, Pay, and Politics in Sweden and West Germany (1989).

solution involves sacrificing participatory democracy to representative democracy, but, within the union itself, prospects for participation seem to be stronger than they do for direct participation within highly diversified pensions. The key is assuring that unions are genuinely democratic. In a democratic union in which people participate, block voting on important pension issues could facilitate a more active form of pension participation.

C. The Trade-Off between Voice and Risk

The most important problem with creating a form of pension ownership that is robustly participatory, especially with respect to workplace governance, is the trade-off between voice and risk. Substantially increasing pensioners' control over internal management of the firm by concentrating pension capital in that, or any single firm, to some extent sacrifices the beneficiary's economic welfare. Funds that concentrate a participant's pension investment in the workplace increase the participant's risk by failing to diversify his or her total investment. The concern about the level of economic risk seems especially acute with respect to retirement investment; most individuals planning for retirement have a low tolerance for risk. This risk profile argues strongly for diversification of pension funds. Modern finance theory establishes that, other things being equal, a diversified portfolio will have less variance in returns and will average higher returns than an undiversified one. Nondiversified plans generally expose participants to greater risk, and this exposure would be magnified if the plan invested heavily in the workplace. Participants already have substantial investments of human capital in the workplace, so reducing their economic risk requires that their pension capital not be unduly concentrated in the same firm.

How much concentration should be permitted depends on making trade offs among several factors. There are, as has already been indicated,[106] political advantages to a fund that concentrates investment in the workplace. An economic advantage is that concentration theoretically should increase the employee's productivity incentives. Moreover, while it increases one form of risk, it decreases another, that is, the risk of job loss. (Employee-owners may still lose their jobs, of course, if the firm fails.) In fact, it is arguable that diversification economically *harms* rather than helps employees. Because workers are so underdiversified in relation to their human capital investment, which is the primary life investment for most, they arguably need better ways of monitoring that investment than the law currently allows.[107] Consequently, if workers become significant shareholders in their employer firms, through either their pensions or ESOPs, they can more effectively monitor their main life investment—their jobs.

Related to these points is a macroeconomic factor: The appropriate level of concentration for a particular fund depends to some extent on the level of risk

106. *See supra* part V.B.
107. *See* Stone, *Labor and the Corporate Structure, supra* note 95, at 73.

in the relevant industry.[108] Diversification becomes more important for firms within industries that have higher levels of risk. Nobody would, or at least should, suggest, though, that anything close to a majority of his or her retirement funds be invested in the pensioner's employer. The more basic point is that the democratic model of pensions has to reckon with an unavoidable trade-off between voice and economic welfare, participation and investment diversification.

VII
CONCLUSION

On balance, the prospects for creating a genuinely participatory pension system do not look strong. Pension-fund socialism may never become a reality, but it certainly is not a reality now. Some of the impediments are practical, and to some extent given, such as the trade-off between participation and diversification. Others, however, are contingent, not given. Fiduciary law has significantly contributed to the passivity of equitable pension ownership. Pension rules could be changed to make the fiduciary office less paternalistic and give greater voice to pension participants. An obvious step is to abandon the rule barring trustees from following participants' preferences in investment decisions. This would enhance participants' control over their jobs and other conditions of their lives. Increasing their control in this way is necessary to enable individuals to develop a sense of responsibility, both for themselves and for their communities.

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108. *See* Simon, *The Prospects of Pension Fund Socialism*, *supra* note 95, at 5.